

Policy Working Papers

June 1987

Number 7

AMTRAK AND THE PRIVATIZATION OPTION

by
Rajni Bonnie Ohri
Economist

Because of the Gramm-Rudman Hollings Emergency Deficit Control Act, both the Congress and the President have been confronted with exceptionally difficult decisions regarding the course of federal spending. Despite the ongoing commitment to deficit reduction, projected federal deficits will be in excess of \$150 billion for the foreseeable future and intense efforts will be required just to keep next year's budget deficit below the previous one. The Gramm-Rudman-Hollings Act (GRH) not only raises the stakes, but also provides enhanced powers to achieve the objective. In 1988 alone, it is estimated that over \$50 billion in spending reductions will be necessary to meet the stipulated target of \$108 billion. By fiscal year 1991, GRH requires that the federal budget be in balance. Meeting these objectives will require an unprecedented assault on federal spending and innovative solutions. That is why the privatization option--shifting the provision of many government programs and services to the private sector--may be the only solution to shrinking the budget deficit without jeopardizing economic growth.

The Budget Dilemma

Even with the enhanced powers provided by GRH, recent history demonstrates that the attainment of substantial deficit reduction targets through spending cuts have been a daunting endeavor. Last year was supposed to be the year that everyone got serious about the budget, but in the end it was business as usual. Although Congress has agreed to the Administration's goal of \$36 billion in spending cuts, it should come as no surprise that this year's deficit is expected to reach an estimated \$180 billion, instead of the \$108 billion target set in the budget resolution and required by GRH.

Despite this bleak outlook, there is a politically attractive solution to the dilemma that offers substantial long-run potential for large savings: A massive and comprehensive program of privatization of every government activity that could be performed by a private sector entity. Although privatization itself is not likely to generate great savings during the next fiscal year, it could yield generous savings as the decade draws to a close. While such potential savings are of major importance in times like these when the deficit hovers near \$180 billion per year, the main public policy attraction of a privatization program is that it is more politically saleable than the usual menu of program freezes and exterminations, and service and benefit reductions. Privatization does not eliminate programs nor does it necessarily reduce services. Indeed, it may even lead to more and better service. Privatization

merely changes the provider by placing a greater share of management and production responsibilities within the more efficient private sector.

The Reagan Administration's fiscal year 1988 budget contains eight privatization initiatives designed to cut a total of \$9.5 billion from the budget deficit. It intends to accomplish this by transferring government functions, wholly or in part, to the private sector. Several programs, such as the sale of Amtrak which will be examined in detail later, were introduced in last year's budget but Congress failed to act on them.

The Privatization Solution

The essential idea behind privatization is to identify those government services that could be more efficiently provided by the private sector. The general rationale of this strategy is to utilize the superior efficiency of the private sector and the competitive pressures of the marketplace to produce such services at the least cost possible. Numerous studies show that private firms often produce at prices which are substantially less than the average cost of similar services produced by the public sector.

Privatization covers several distinct ways in which the provision of government services can be shifted to the private sector. The three principal privatization mechanisms are load shedding, contracting out and vouchers. Load shedding refers to the process whereby the government transfers complete financial and production responsibilities to the private sector. While load shedding represents a valuable tool for privatizing some types of government activities, it is of limited usefulness in the case of certain essential public services and income redistribution programs. National defense, certain aspects of public health and basic law enforcement are examples of functions that would be difficult to shift to the private sector.

The other two methods of privatization, contracting out and vouchers, are partial privatization strategies and can be employed to improve the delivery of public goods and operation of income transfer programs. Contracting out allows the government to establish the objectives for programs and finance their cost, but places the responsibility for actual provision of the service in the private sector. Cost savings at all levels of government have been achieved through contracting out in areas ranging from garbage collection at the local level to medical care for the aged at the federal level. With vouchers, the government continues to fund the program and sets its objectives by providing a cash grant that is tied to a specific type of purchase. Food stamps and student loans are examples of existing voucher programs. A voucher is usually provided to classes of citizens believed by the government to earn insufficient income.

Amtrak: An Excellent Privatization Opportunity

Amtrak offers perhaps the most dramatic example of a privatization opportunity. The Reagan Administration, as part of its deficit reduction package, proposed the elimination of Amtrak subsidies and the termination of all Amtrak assets, the majority of which are in the Northeast Corridor, to one or more private sector companies, rail passenger organizations or other entities. This move to cut federal largesse has brought forth howls of protest from a small but vociferous clique of rail passengers, Amtrak management and employees, and selected members of Congress.

For over 100 years, inter-city rail passenger service in the U.S. was provided by private carriers. But in 1969, burdensome regulations, declining ridership and mismanagement in the passenger rail industry forced it to the point of economic collapse. The catastrophic losses suffered by the industry threatened the viability of passenger rail service, thus prompting Congress in 1970 to establish the National Railroad Passenger Corporation (Amtrak) as a quasi-Government, for-profit corporation, responsible for organizing and managing a national system of rail passenger service. Since 1971, Amtrak has received \$12 billion in federal subsidies for its intercity passenger services, and is expected to require another \$7 billion over the next decade. When establishing Amtrak, Congress thought that a one time subsidy was all that was needed and that Amtrak would be self-sufficient thereafter. On the contrary, subsidies have continued and they now exceed \$600 million a year, covering all capital spending and nearly one-half of operating costs. During its short history under federal ownership, Amtrak has grown increasingly reliant on federal operating subsidies. Between 1971 and 1981, annual taxpayer contributions to Amtrak grew from \$140 million to over \$1.2 billion. And as Table 1 shows, operating grants totaled about \$8.5 billion. Not included in the table is another \$1.1 billion in federal loan guarantees.

Table 1

Budget Authority for Amtrak
(\$ Millions)

Year	Grants	Northeast Corridor Purchases	Improvements	Total
1971	\$40	--	--	\$40
1972	80	--	--	80
1973	90	--	--	90
1974	149.1	--	--	149.1
1975	276.5	--	--	276.5
1976+Q*	602.1	--	\$50	652.1
1977	575.7	\$25	200	800.7
1978	666	25	400	1091
1979	730	24	490	1244
1980	851.4	12	381	1244.4
1981	906.3	--	350	1256.3
1982	735	--	168	903
1983	780	--	115	895
1984	735	--	100	835
1985	684	--	27.6	711.6
1986	587.5	--	12.5	600
1987	602	--	--	602

* "Q" was the transition quarter when the federal fiscal year was changed in 1976.

Source: Congressional Research Service, Amtrak: Background and Issues in the 99th Congress, September 1985, and Office of Management and Budget, Budget of the United States Government, FY 1987.

But persistent pressure from Amtrak's management and railroad passenger organizations, who continue to claim that Amtrak is making substantial progress, have convinced Congress to maintain subsidies to Amtrak, thereby failing to end the taxpayer's burden. Relying on scare tactics, Amtrak supporters pretend that there are only two solutions open to Congress: continue full federal subsidies or eliminate the service. Yet there is a third solution: privatization of whole or part of the system. This would be a sound alternative politically by giving key constituencies an ownership stake in the railroad and eliminating subsidies through improving efficiency rather than closing the system down. As long as federal subsidies continue, there will be little incentive to recover costs. Replacing subsidization with privatization will allow consumers rather than politicians to decide the fate of intercity rail passenger transportation.

Poor Track Record

Amtrak's performance under government ownership shows that the railroad has been a consistent money loser. In fiscal year 1972, its first year of operation, Amtrak reported a deficit of \$153 million. By 1983, Amtrak's deficit had mushroomed to \$805 million, with the prognosis for annual losses in the \$700 to \$900 million range for the foreseeable future. Interestingly, the official losses reported by Amtrak are only the tip of the iceberg of public subsidies. During fiscal years 1979 through 1983, losses have amounted to over \$3.8 billion. However, these do not include the interest-free, 99-year renewable loans it has received from the federal government. When total government assistance to Amtrak over those years is added up, the sum reaches a staggering \$6.3 billion.

Other typical measures of Amtrak's progress such as number of passengers, passenger miles of travel and the market share have declined rather than advanced over the past few years. True, in the first decade of this century, railroads were carrying 95 percent of all intercity travelers. But competing modes of passenger transportation soon reached into the railroads' market share of traffic. By 1970, airlines dominated inter-city passenger travel, carrying 73 percent of the traffic, buses served 16 percent and railroads accounted for only 7.2 percent. These shifts in passenger volume, coupled with a rapidly rising rate of private automobile travel, left the railroads with very little passenger patronage. But politicians seem destined to continue subsidizing a form of transportation which now carries less than one-third of one percent of intercity traffic. In 1984, Amtrak boarded 11 million passengers at its 25 busiest stations. In contrast, airlines carried 202 million passengers at the nation's 25 busiest airports. And, since 1981 rail passenger miles have increased by only one percent annually, with short distance performance falling rapidly. In addition, Amtrak cannot be considered a federal program that benefits low-income consumers. Over 55 percent of Amtrak's passengers have an annual income of at least \$30,000, while only 28 percent of the general population have incomes that high. As a result, the effect of continued Amtrak subsidies is to redistribute income upward.

Clearly, the increase in subsidies to Amtrak have only created both inefficiency and inequities. The average federal handout per passenger on all Amtrak routes is between \$25 and \$33, up from \$3 per rider in 1973. Indeed, no other form of intercity transportation receives close to the taxpayer assistance

extended to Amtrak. The 1982 CBO (Congressional Budget Office) study found that per passenger mile, Amtrak subsidies were over 100 times larger than subsidies to air, bus or auto passengers. Many analysts have asserted that it would be cheaper for the government to provide free airline tickets for all those who travel on Amtrak. Numerous studies have shown that it is those modes of transportation which are least subsidized that have done the best job of lowering costs. Between 1975 and 1983, the real cost per passenger mile declined by 19 percent for both commercial aviation and auto travel. The two most heavily government subsidized modes of travel, Amtrak and public transit, experienced increases of 19 and 13 percent respectively. This is powerful evidence for the advantages of a free and competitive market versus bureaucratically managed public monopolies.

The Key to Success

Although there is no evidence that the preservation of Amtrak is justifiable, it is still illuminating to consider the railroad's fate if the privatization option is chosen. The key to successful privatization is to convince Congress that by transferring the railroad or portions of it to private ownership, its long-term sustainability will be assured.

At no cost to the government, Congress can ensure that elimination of Amtrak's subsidy is accompanied by a transfer of ownership to those groups that are most concerned with its survival: current management, employees, passengers and rail groups. One strategy that has been considered is converting the government's preferred stock in Amtrak to common stock and offering it to these interested groups. They will then have an incentive to discover ways to make the railroad financially viable.

Another option deals with contracting out specific services of Amtrak. Because its work rules are archaic, its wage levels so high, and its labor protection provisions so unique and expensive, the railroad industry performs all services at higher costs than any competitor. For example, Amtrak suffers significant losses on its food service, running \$9 million in the red annually on the Northeast Corridor and \$33 million on long distance trains. Contracting out Amtrak's food service would both improve its food quality and reduce losses. At the very least, the contractor would not be bound by stifling work rules of labor agreements that drive up the cost of onboard train services. According to the Federal Railroad Administration, contracting out the food service could save a minimum of \$15 million a year.

The most feasible Amtrak privatization strategy would be the consideration of the Northeast Corridor, clearly the route most amenable to private ownership and the political heart of the coalition to retain federal subsidies for the entire system. In the past six years, the Northeast Corridor trains have reported losses of about \$20 per passenger, amounting to over \$250 million per year. Amtrak's sustained losses have been caused by a number of factors such as high overhead, excessive labor costs, low productivity and mismanagement that could be avoided under private ownership.

For example, a large part of the railroad's current problems can be attributed to unsound political decisions. As long as Amtrak receives federal subsidies, politicians will seek to bend its business decisions to their own

ends. Politics also interferes with Amtrak's ability to engage in long range business planning. As a federal corporation, Amtrak must appeal to Congress for funding, thereby leaving many operating decisions such as its capital investments, to be based on short term political considerations, not long term financial viability. Congress also requires Amtrak's Northeast Corridor to subsidize city commuter trains in the region. According to the Federal Railroad Administration, if private operators owned the Corridor, they could earn \$80 million annually by charging the commuter trains for use of the track.

In addition, the railroad's labor productivity is among the lowest of all intercity transportation. The 1982 CBO study concluded that in 1981 Amtrak's labor costs per passenger mile was two to three times higher than those in the airline and bus industries. This differential is mainly attributed to the restrictive features of railroad labor agreements as well as higher wage rates. The "labor protection" obligation, common in the railroad industry, effectively prevents Amtrak from saving money by dropping its least profitable routes. As long as Amtrak is government-owned, employees have no incentive to improve efficiency as any savings would come out of their own pockets. If private firms could reduce the Northeast Corridor's labor costs by 30 percent, a feasible target, operating costs could drop by as much as \$100 million.

Besides cutting costs, some critics believe that Amtrak could increase revenues by marketing itself more effectively. Competition would force private firms to offer better and more efficient service in order to attract rail passengers. Federal Railroad Administration data reveals that fewer passenger miles were recorded on the Northeast Corridor in 1986 than in 1981, and 50,000 fewer passengers rode the Corridor trains. These statistics suggest that an innovative marketing strategy, along with a more responsive scheduling system, could increase Amtrak's revenues substantially while slashing operating costs for low utilization trains.

Taking into consideration these potential reforms, a privatization strategy for the Northeast Corridor appears to be a promising solution. Properly managed and in the right markets, passenger railroads can operate effectively and profitably without government subsidies. For example, last year the Alaska Railroad, a passenger rail line run by the state of Alaska, earned a \$2 million profit. And, in early 1986 private investors entered the rail passenger market and began the operation of the Tex-Mex Express, which travels the 160 miles between Corpus Christi, Texas and the Mexican border, and earned a profit in the first year.

One Possible Strategy for the Northeast Corridor

One recently developed Amtrak privatization strategy is modeled after the 1982 British sale of the government-owned National Freight Corporation (NFC), Britain's largest trucking establishment. The company was sold for 53 million pounds (\$80 million) through an employee buy-out arrangement, with current and retired NFC employees obtaining over 80 percent of the equity. Since privatization, the employee-owned NFC has seen the value of their stock increase more than twenty-fold.

Those advocating privatization claim that Amtrak's Northeast Corridor could be privatized in a similar manner. First, transfer 80 percent of the

Northeast Corridor, including its track, real estate, facilities and equipment, to Amtrak workers and management by issuing them stock in a newly formed private company. Employees would have the right to retain or sell their shares to other employees. By turning the assets of the Corridor ("assets" which yield the government nothing but losses) over to the private sector in return for terminating the subsidy, a net saving to the taxpayer results.

The Corridor's employees should be offered the option of either working for the new private company or joining Amtrak's other operations. Each worker choosing the new company would be given an annuity worth the employee's accumulated pension benefits, to be cashed in upon retirement. The federal government must also guarantee to honor existing severance pay agreements, which provide up to six year's pay, to any worker who became displaced because of the transition to private ownership.

The remaining 20 percent of shares in the new company would be given to Amtrak's Northeast Corridor riders who have accumulated "frequent passenger" status (determined on the basis of the number of an individual's passenger miles), a strategy similar to the airlines frequent flier program. The new private company would maintain a minimum of 80 percent of the existing passenger miles now traveled by Amtrak in the Northeast Corridor for a twenty-year period.

The potential saving that the government derives from such a change could be substantial. The CBO estimates that eliminating federal support for Amtrak would save \$610 million in outlays in 1987 and \$3.2 billion from 1987 through 1991. And if sold to the highest bidder, the disposal of Amtrak's assets will generate revenues estimated to be \$1 billion in 1988. But the real potential attractiveness of privatization goes beyond the budgetary benefits. It includes the opportunity for more efficient service at much lower costs, and the creation of political constituencies who stand to directly benefit from the change in ownership. In effect, the plan involves the buying out of the workforce with assets that are of no value to the government and taxpayers, but can be of value to employee-owners. The new owners would realize that with reasonable management the Corridor could be turned into a profitable operation, where profits accrue directly to the employees since they own the capital stock of the railroad. Individual users of the system would risk some changes of service but most would gain from privatization--lower costs and more efficient service. And the taxpayer would ultimately gain. Annual subsidies of \$250 million on the Northeast Corridor alone would be eliminated in return for potential gain in tax revenues.

Numerous alternative privatization strategies for Amtrak also exist. Another strategy consists of auctioning off Amtrak assets to private passenger rail companies. It may also be possible to model the sale of Amtrak after the recent privatization of Conrail. In the largest stock offering in Wall Street history, this first major privatization project of the Administration netted \$1.65 billion. In addition, Amtrak could be merged with another railway or transportation company.

Conclusion

A move towards the privatization direction was recently taken by the Department of Transportation. On March 6, Secretary of Transportation Dole announced the formation of a Commission to develop a comprehensive approach for

eliminating federal subsidies for Amtrak while preserving economically feasible rail passenger service. The Commission will study a wide range of creative approaches, including proposals for private investments, state subsidies and employee stock ownership plans, and report to the Secretary in six months.

For the privatization of Amtrak to be successful, all those with with a stake in the railroad must be convinced that it has a profitable future if placed in private hands. Although critics of privatization will often acknowledge the gains to the federal treasury from asset and enterprise sales, they dispute the existence of subsequent operating efficiencies that allow the private supplier to provide the same service at lower costs. Arguing that the government can do it more cheaply because it is nonprofit and free of state, local and federal taxes, these critics fail to consider the powerful discipline that the competitive marketplace imposes on private business and how this can be translated into lower costs and improved service.